Delaware Banker

Fall 2014
Vol. 10 No. 4

Earthquake or Aftershock?

The Coming Dodd-Frank Integrated Mortgage Disclosure Requirements

PLUS!
Special Section: 2014 Delaware Trust Conference!

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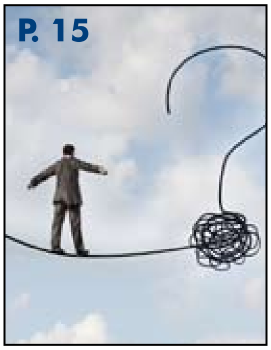

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SUBMISSIONS
Delaware Banker welcomes news items from members of the Delaware Bankers Association. The Editors reserve the right to refuse any advertising or editorial copy deemed unsuitable for publication. The Editors reserve the right to set the publication date in accordance with the Association's needs. Direct submissions to Greg Koseluk at greg.koseluk@debankers.com

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View from the Chair

by
Rodger Levenson
Executive Vice President
WSFS Bank

Chairman
Delaware Bankers Association

"Are you ready for enhanced mobile banking, Apple Pay, and Walmart's new money products?"

Welcome to the Trust Edition of the Delaware Banker Magazine. Having just completed our 9th Annual Delaware Trust Conference I am pleased to report that it was a resounding success, breaking all previous attendance records. This edition of the magazine will highlight the members of the DBA Trust Steering committee and the generous Sponsors who made the program possible. Special kudos to Cindy Brown, Trust Committee Chairwoman, and a DBA Board Director, for leading our efforts and DBA staff members Greg Koseluk, Margaret Cregan and Renee Rau for organizing and delivering this major production. I hope you enjoy this month's magazine.

One of the benefits of being the DBA Chairman is being given the opportunity to attend the American Bankers Association's Annual Convention in mid-October. The three day event covers topics which appeal to a broad spectrum of bankers and Directors. Political pundits such as conservative Tucker Carlson of Fox and Friends (a guest speaker at the DBA Annual Meeting a few years ago) and liberal Bill Press, of the Bill Press Show (Bill grew up in Delaware City), came together to discuss the political landscape of mid-term elections, and surprisingly agreed on a few points. Ken Burns, a celebrated producer and director (and University of Delaware graduate), discussed historical impact and the American value system. I find it interesting that at least for this convention, Delaware had a seat down front.

For me, there were two main takeaways from this meeting which touched the banker in me. The first was the keynote speech delivered by Dr. Robert Gates, former U.S. Secretary of Defense. Secretary Gates drove home the fact that cyber threats are intensifying in the modern global network and that we as citizens and business people better get up to speed on the issue. He spoke about the world of hacking, espionage, drones, and terrorism, not as a bystander, but someone, who as former Director of the CIA and Secretary of Defense has been thoroughly engaged. His message of being prepared is something I will not soon forget both as a citizen and banker. Highlighting the importance of this subject there were two major panel discussions on the program covering cyber threats and data breaches, with participants from IT, the government, and the banking industry.

The second takeaway was that there were five presentations on the future of banking. These sessions covered digital technology, marketing to millennials, reducing cost and inefficiencies in the branch, the 21st Century Banker ,and one on emerging trends in payment systems. Are you ready for customers that refuse to enter a branch, only get the news online (don't see newspaper ads), and get bank referrals from facebook friends? Are you ready for enhanced mobile banking, Apple Pay, and Walmart's new money products? If you are not, I would strongly suggest you get ready quickly!

President's Report

by
David G. Bakerian
President, CEO & Treasurer
Delaware Bankers Association

"We need your input to maintain the quality trade association that you have come to expect."

In September, as promised, we circulated a Delaware Bankers Association Program Survey to our financial institution members. We asked for feedback on our current programs and for suggestions for new programs to assist the DBA in designing a strategic plan for the next 18 months. We are still waiting to hear from a number of banks, but we thought you may want to see a preliminary summary of what we have received so far.

Committees

Of our 6 major committees (Government Affairs, Regulatory Compliance, Human Resources, Trust, Education, and Electronic Fraud) the majority of responders rated Government Affairs, Regulatory Compliance, and Trust the highest. New suggestions included an enhanced Cybersecurity Committee, and a discussion group for Community Reinvestment personnel.

Seminars/Education/Training

The DBA currently offers the following: Teach Children to Save Day, ABA On-Line Courses, Regulatory Compliance School, Webinar/Telephone Seminar Series, College Affiliate Degree Program, BSA Seminar, BSA for Trust Personnel, Delaware Trust Conference, Legislative Reception, Senior Officer Washington Visit. The most popular programs were those that allowed for interaction with Federal and State officials and regulators. Responders suggested we have more seminars with Federal regulators and conduct a "Day at the State Capitol" program for Delaware bankers.

Emerging Leaders

The DBA asked if our members would support an emerging leaders or young bankers program. The responses were generally supportive, but on a different scale and scope. Some supported a conference that focuses on government relations and industry issues. Others supported the DBA partnering with other groups to focus on leadership skills.

Elder Financial Awareness

The DBA asked members if they would support the Association playing a coordinating role in elder financial awareness and protection. The response was overwhelmingly positive. It was generally felt we should support in-house training for our bankers and outreach programs for the elder community.

As mentioned earlier, we are still waiting for some more member responses before we complete our project. We will then send the results to the Delaware Bankers Association Board of Directors for guidance on priorities and implementation. If you have not responded yet, and would like to weigh in, please feel free to send me an email at david.bakerian@debankers.com on any and all of the issues we discussed above. As a service organization, we rely on your direction. We do not want to continue offering programs that you will not use, and we do not want to start new programs that miss the mark. We need your input to maintain the quality trade association that you have come to expect. Thank you for your time.

Sincerely,

What's New at the DBA

New Members
Associate Members

Atlantic Trust Company
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Wilmington, DE 19801-1186

Gabrielle Bailey
Director of Delaware Trust Services
Phone: 302-884-6775
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Atlantic Trust delivers personalized, integrated and objective wealth management solutions for affluent individuals and multi-generational families, as well as foundations and endowments. Across the U.S., our experienced professionals strive to provide the highest-quality client service with strong investment performance and a fiduciary mindset.

Member News
Discover Bank and Mayor Williams Announce the Grow Wilmington Fund

Wilmington Mayor **Dennis P. Williams** (pictured above) joined **James J. Roszkowski**, President of **Discover Bank**; Bill Young of National Development Council; and the Mayor's Office of Economic Development to announce the Grow Wilmington Fund, an innovative, loan fund for established small businesses. The fund has been created through the cooperation of Wilmington UDAG Corporation, Discover Bank and the National Development Council. The Office of Economic Development looks to use the Grow Wilmington Fund to promote job growth and economic development in the City of Wilmington through the expansion of existing businesses and recruitment of new businesses. Grow Wilmington offers attractive interest rates, extended terms to benefit eligible Wilmington businesses.

Five Delaware Financial Institutions and Three DBA Associate Members Recognized as "Top Workplaces"

Five Delaware Financial Institutions - **WSFS**, **Capital One**, **Discover Financial Services**, **Brandwine Trust Company LLC**, and **Fulton Bank Delaware Division** - were recognized as Top Workplaces by the NewsJournal. WSFS, Capital One, and Discover were recognized in the the Large Workplace category (400 or more employees), while Brandywine Trust Company and Fulton Bank Delaware Divison were recognized in the Small Workplace category (35 - 124 employees). **Richard E. Carlson**, president and CEO of Brandywine Trust Company was also recognized with a special leadership award in the small company category. Also recognized were DBA Associate Members **Morris James LLP**, in the Midsized division (125 - 399 employees), and **Belfint, Lyons, & Shuman PA** and **Santora CPA Group** in the Small Workplace category. Seventy companies across the State of Delaware participated in the "Top Workplaces" survey, which has been analyzing Delaware's business community for the past fourteen years. The Top 45 were recognized in three categories: Top 10 Large, Top 10 Midsize, and Top 25 Small employers. In the Large Workplace category WSFS Bank ranked third, Capital One ranked fourth, and Discover ranked sixth. Morris James ranked second in the Midsized category. In the Small workplace division Brandywine Trust ranked second, Fulton Bank ranked seventh, and Belflint, Lyons, & Shuman ranked ninth. Congratulations to all those recognized!

Cover Story

Dodd-Frank Earthquake or Aftershock?

Either Way, the Coming Integrated Mortgage Disclosure Requirements Is Going to Rock Your World!

By Walter Young, Senior Compliance Manager
FIS Regulatory Advisory Services

If you are still active in mortgage lending, you are probably recovering from the impact of the Dodd-Frank regulatory changes of January 2014. The new Ability to Repay and Qualified Mortgage rules coupled with massive changes to the servicing rules for mortgage loans, changes to high cost mortgages, higher priced mortgages, loan originator compensation standards, appraisal standards, and disclosures, and a number of other regulatory "odds 'n ends" detail the fact that virtually no aspect of consumer mortgage lending went unchanged. A "new normal" is now becoming clear for mortgage lenders. For an industry that has never dealt well with change, the changed lending environment has been, at best, difficult to deal with. A fair number of lenders have dropped certain loan programs and some have dropped completely out of the mortgage lending business. Their decisions were based on a belief that the massive regulatory changes made the business overly expensive, and overly risky with too little reward.

Consumers are now finding it more difficult to obtain mortgage financing, and housing is still going through a long-term slow motion recovery from the doldrums of just a few short years ago. Taken individually, each and every one of the many changes are worthwhile and beneficial for the industry and for consumers. Taken together, however, and implemented with blinding speed, the cumulative impact has resulted in chaos in mortgage lending. Even the simplest of mortgage-related tasks has become enveloped in risk. Lenders fear regulatory criticism when they venture into what was formerly a low risk lending activity, as well as an increasingly litigious borrower population.

So into this unhappy regulatory environment, comes another round of Dodd-Frank mandated regulatory change: The marriage of TILA and RESPA disclosures. The logic behind this is quite sound and it is, in fact, something that many industry professionals have been seeking for decades. The existing residential mortgage disclosure scheme admittedly has its failings. It doesn't do a great job of informing consumers or of helping them understand when they have found mortgage products that best serve their needs. On the flip side, most consumers never actually read the disclosures they are given anyway. And while the existing disclosures aren't all they probably should be, they at least have been stable long enough now so lenders have become adept at generating them correctly. These disclosures are one of the few "constants" in a chaotic mortgage lending world, and most lenders see little in the way of a pressing need to fix "what ain't broke."

The Dodd-Frank Act, however, required that existing mortgage disclosures be merged together and made more useful for consumers. From the day it was founded, the CFPB has spent a great deal of time and effort crafting integrated disclosures, creating a disclosure process that best educates consumers and that helps them shop for the best loan for their needs. Whether you believe these regulatory changes are needed or beneficial, the reality now is that the new disclosure rules will become mandatory on August 1, 2015.

Summary of the Integrated Disclosure Rules

As with the existing TILA and RESPA disclosures that the Integrated Disclosures replace, you will need to provide consumers with two distinctive types of disclosures – early and closing. The early "Loan Estimate" disclosure replaces the old Good Faith Estimate from RESPA and the old early Fed Box disclosure from TILA. Some of the existing rules and standards are preserved but a number of significant changes will take place in both form, content, and operational standards relating to the disclosures. The Closing Disclosures will replace the old HUD-1 or 1A and final TILA Fed Box disclosure documents. The timing of delivery of the Closing Disclosures is changed significantly as have many of the operational standards surrounding delivery of Closing Disclosures. Who is responsible for the Closing Disclosures has also changed. Formerly, the settlement agent was responsible for providing those disclosures, although the lender was still held accountable for their accuracy. Now, the lender is responsible for providing Closing Disclosures to the borrower, although the lender may contract with the settlement agent to do that on its behalf, and the settlement agent remains responsible for providing the Closing Disclosures for the seller in transactions involving a buyer and a seller.

While the HUD-1 or 1A documents have always supposed to have been available for review by the borrower one day before loan closing, now the borrower must receive a copy of the Closing Disclosure **three business days** prior to loan settlement. If the disclosure is mailed, the borrower is presumed to have received the disclosure three business days after the date on which it is dropped in the mail. This timing for borrower's receipt of the Closing Disclosure will cause a significant alteration to the logistics of loan closings.

Both the Loan Estimate and Closing Disclosure are substantially different from what their predecessor documents looked like, and the difference is far more than cosmetic. The contents are different, the organization is different, and there are specific, finite standards for each and every field of information to be displayed on the two disclosures. You are even told when to bold and when not to bold items, how many decimal places dollar figures are to be carried to, and how to properly display percentages that are disclosed, including a standard that tells you that if an interest rate is to be disclosed to three decimal places, you would disclose a rate of 4.003% including the decimals, but a rate of exactly 4.000% should be displayed as 4% without display of the three zeros after the decimal point. Minute details like this make for many more opportunities to render non-compliant disclosures.

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The changes triggered by the Integrated Disclosure rules are significant enough that lenders still staying in mortgage lending will need to devote a significant amount of time, effort, planning, and training well in advance of the implementation date of August 1, 2015. Assistance from automation vendors is also critical because you will never be capable of complying with much of the minutia absent reliable loan document software.

New Challenges and Issues

The new disclosures that go live August 1, 2015 are different enough that you will need to completely rethink and relearn everything related to how they get prepared and how they get used. Do not underestimate the amount of time needed to get ready for the new disclosure world. Simple things like disclosing time periods as years or as months have specific, often non-intuitive standards that must be relearned or disclosures will be done wrong. Product names even have specific naming conventions that have to be understood and correctly displayed on disclosures. Where things are placed on the disclosures is different and the order in which items are presented is significantly changed. In short, this is all brand new, so you will need to retool from the very bottom up.

Tolerance standards and finding out when they are violated. RESPA tolerance standards have been significantly tinkered with so that many more items will be subject to the zero tolerance standard and most others will fall under the 10% aggregate tolerance standard. This will make it all the more essential that lenders know with certainty what items will cost because underestimating costs will result in costly cures where lenders end up reimbursing money simply because they failed to keep track of what various settlement services cost. If you have any affiliates that provide settlement services, those costs will fall into the zero tolerance bucket now even though those costs formerly were part of the 10% aggregate bucket. It is critical that you know when services will be provided by affiliates because that will impact your tolerance tracking and cure standards.

While page 3 of the old HUD documents currently provides a nice, easy to follow "cheat sheet" that reminds both lender and borrower when tolerances have been exceeded, the new Closing Disclosure no longer provides that nice, clear and clean audit trail for tolerance tracking. Consequently, you will need to create your own reliable method for determining when tolerances have been exceeded and cures need to be provided. You might want to check now with your software vendor to see if it will create a reliable tracking mechanism for that purpose or if you will be left to your own devices to figure out how to track tolerances starting August 1, 2015.

Changed circumstances and when revised early and closing disclosures are allowed or mandated. Some of the Regulation Z and RESPA standards relating to when revised early disclosures were permitted and/or mandated have been preserved, but they have been changed in subtle yet significant ways. The definition of changed circumstance remains consistent with current RESPA standards, but what is allowed to happen as a result is slightly changed. If the changed circumstance results in a zero tolerance cost increasing, you are allowed to (and will want to) issue an updated Loan Estimate (or in some instances where the Closing Disclosure has already been issued, a revised Closing Disclosure). However, the rules for increases to the 10% aggregate tolerance category of costs are different. You only are **allowed** to issue a revised Loan Estimate or Closing Disclosure if the increased cost as a result of the changed circumstance increases the 10% aggregate cost category in excess of 10%. If the increase causes the costs to increase by less than 10%, you are NOT permitted to provide an updated disclosure. If you have an updated disclosure present when you are not allowed to have one, you must compare the final costs on the loan closing disclosure with the costs on the last *validly issued Loan Estimate*. This will make it much harder operationally to figure out when updated Loan Estimate disclosures should be issued when changed circumstances occur. This is especially true when you have not yet determined which costs will be subject to a zero or to the 10% aggregate tolerance because your customers have not yet decided who to use for those settlement costs.

Deciding which vendors to trust and quality assuring the revised disclosure process. Since the length and complexity of Loan Estimate and Loan Closing disclosures has taken a quantum leap forward, you may want to evaluate who you trust to prepare those disclosures for your institution. If you have allowed brokers in the past to prepare the early GFE disclosures, you might want to pull that job in-house. If you have settlement agents who have not done a very good job of preparing HUD-1s for you in the past, will you trust them to prepare infinitely more complex Closing Disclosures, especially when they have to reach the borrower's hands at least three business days before the scheduled loan closing date? You again may decide to bring that task in-house, and fortunately, the new rules allow you to do that. If you do, however, you still have to work out logistical issues for how to incorporate changes made at loan closing when costs invariably change as a result of last minute negotiations between buyer and seller. The regulations give no hint as to how these types of things are supposed to be handled on and after August 1, 2015, but you will have to figure them out before that date rolls around.

Evaluating automation vendors. The more you study the details of the Integrated Disclosure rules, the more it becomes glaringly obvious that success in dealing with this next wave of chaos will be impossible absent capable automated systems to help prepare these key disclosure documents. Now is not too early to begin evaluating how prepared your current document preparation vendor will be to deal with the new disclosure world that will arrive all too quickly. If you don't use automated tools to prepare these disclosures now, you had better acquire the tools or prepare to exit the market when the new rules go into effect.

Getting Prepared

Start preparing now because it will take a considerable amount of time and effort to be ready for this next compliance earthquake. The rules are available now. The CFPB has issued a Small Entity Compliance Guide, a Guide to Forms, and a Disclosure Timing Guideline – all and more of which are available at: http://www.consumerfinance.gov/regulatory-implementation/tila-respa/

Walter Young brings nearly 30 years of compliance, audit, operations, and regulatory experience in the financial services to his clients at FIS, where he answers compliance questions and provides compliance advice to thousands of bankers each month as part of the FIS Regulatory Advisory Services team. FIS Regulatory Advisory Services strengthens the overall corporate mission by providing oral and written compliance advisory services to financial institutions. It is the industry's most respected compliance resource. Walt and the entire compliance staff are responsible for ensuring Bankway™ – FIS Banking Solutions' flagship banking software product – is compliant, and that the documents produced during product opening meet state and federal requirements. Walt began his career in banking with the Comptroller of the Currency. He has been responsible for managing regulatory compliance, internal audit and operations functions in commercial banking and thrift organizations ranging in size from $200 million to $4 billion. Over the years, Walt has "lived with" compliance issues, as a regulator, as a manager of loan operations and as a compliance officer. He has repaired compliance "meltdowns" in three large banks, managed Regulation Z file search/restitution projects and provided administrative support and guidance to Community Reinvestment Act programs in both "traditional" and "niche" banks. Walt's credentials include: Certified Bank Auditor (CBA) (Gold Award recipient); Certified Internal Auditor (CIA); and, Certified Regulatory Compliance Manager (CRCM). He is a graduate of Hofstra University, Bachelor of Business Administration (Magna Cum Laude).

Risky Business

Protecting Your Company Against Threats

by Tony Lunger
Senior Private Client Advisor
Wealth Advisory Services
Wilmington Trust

Entrepreneurs are risk takers by nature, leveraging their insight, hard work, and capital to create successful companies. But when the company you own is your main source of financial security, you need to protect it from unforeseen risks—like natural disaster, legal liability, and crime.

Unfortunately, many entrepreneurs who become business owners don't think about specific kinds of risk until they've experienced a threat first hand. Yet planning ahead is critical to mitigate many different kinds of risk and protect your business from losses. What kinds of risks should you consider? Here are some key areas where you may wish to prepare and protect your business:

The Emerging Risk of Cyber Crime

The newest threat to businesses of all sizes is cyber crime. The Center for Strategic and International Studies (CSIS) estimated this June that cyber crime costs the U.S. economy at least $445 billion a year, with individuals losing $160 billion and companies accounting for the remaining $285 billion.[1]

How can cyber crime affect businesses? Consider the hypothetical experience of William, the third-generation owner of a very successful manufacturing company. While not "high tech" in the traditional sense of the word, William's company uses very sophisticated proprietary technology in its factories—and keeping it out of the hands of competitors is an important business objective. Imagine his dismay when he learned that the company's computer systems had been hacked and that processes that he had spent millions to develop were now in the hands of overseas competitors.

Think about this scenario with Lucinda, the owner of a high-end children's clothing firm. Lucinda had been selling for years through her company's website when customers began to complain about unusual credit card charges. Lucinda's payment systems had been hacked, and she spent the next several years trying to rebuild trust among her customers.

The risk is so great that today, many business owners are seeking protection through cyber security insurance. These policies typically cover damage to digital assets, business interruptions, and, sometimes, reputational harm. They can defray liability costs if you are sued, and may pay for forensic investigations, customer notification, credit monitoring, and legal and public relations services.

Large companies have been more likely to purchase this type of coverage than smaller ones historically, but this is changing. A 2010 survey of middle market executives found that roughly one-third of business owners currently had cyber security insurance—and an additional 25% planned to buy it in the next 18 months.

Asset Concentration Strategies

Cyber crime is, of course, not the only risk that business owners face. Asset concentration is another important threat—since the business makes up such a large proportion of an owner's net worth, he or she is especially vulnerable to changes in its value.

Consider, for example, the following scenario: An entrepreneur has owned a successful trucking company for many years. As he approached his 60s, he felt it was time to consider options for turning the wealth he owns through his business into a financial portfolio that could support him in his retirement years. He also wanted to minimize his exposure to the risks inherent to his business—liability lawsuits, for instance, and the possibility of a cyclical downturn.

The best solution for his situation was to position his company for sale to potential buyers and structure a deal that provided substantial liquidity. Through this deal, the buyers would keep him on as CEO for a period of five years, so he would still manage the company he built, while knowing that regardless of how the short-term economic and business cycles affect the business, he and his wife would be financially secure in retirement.

Even if you're not ready to sell your company, wealth planners who specialize in business issues can help you diversify while retaining control. They can implement strategies like exchange funds and charitable remainder trusts that allow you to sell shares in your company without realizing capital gains. They can show you how to structure and finance a transition to the next generation of owners, whether they are your children, trusted employees, or an outside buyer. And they can help you determine the right entity structure for your business—whether a corporation, partnership, LLC, or series LLC—to best protect your interests.

Business Risk

Your company may also be exposed to risk because of the nature of your business. For instance, depending on your situation, you may need special coverage for accidents, weather events, or product liability. A business planning specialist can help you identify the most important threats you face, then arrange coverage through a carefully designed insurance program specifically for your company.

Fiduciary Risk

If your company offers qualified retirement benefits to its employees, you may also be exposed to another kind of threat: fiduciary risk. Essentially, this is the risk that your employees may sue you for not managing the corporate retirement plan in their best interests—for example, choosing funds for the plan that aren't appropriate or using vendors who charge above-average fees.

You can mitigate these risks by partnering with experienced retirement specialists. These professionals can help you meet your fiduciary responsibilities. They can advise you on qualified

Risk Managment

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retirement plan vehicles like cash balance and benefit focused plans that allow you to amass significant amounts of money for your own retirement while fulfilling your obligations to employees.

Think About Risk Before It Happens

These are some of the major risks that business owners face, but they are by no means the only ones. Your own risk exposure will depend on many unique factors—the nature of your business, your own personal tax and financial situation, and estate and business succession planning considerations. But whatever risks you face, it's important to plan ahead for them and develop an integrated, cohesive strategy for minimizing them. To get started, talk to your personal wealth planning specialist about what you should be doing to protect your business.

Tony Lunger is responsible for heading up client development efforts for Wealth Advisory Services throughout the Delaware region. His duties include working closely with commercial banking officers and trust professionals to provide comprehensive wealth management advice to high-net-worth individuals and families, entrepreneurs, business owners, and executives. He works closely with clients and their advisors to develop financial strategies that help clients meet their current needs and plan for their long-term objectives. Tony ensures that clients receive the appropriate blend of services based on their unique needs, including investment management, tax and estate planning, custom lending and banking solutions, philanthropic, trust, and family office services.

[1] Net Losses: Estimating the Global Cost of Cybercrime," Center for Strategic and International Studies, June 2014

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The Family Bank

Families who plan for long-term financial development of next generations seldom regret it... You can bank on it.

by Joyce Crivellari
Senior Wealth Strategist
UBS Financial Services Inc.

Financial and tax professionals often hear clients say…

"I am worried about the financial maturity of my son. He is making decisions that may impact the stability and longevity of our family's wealth and legacy."

Or...

"I am so proud of both of my children. They are doing such great things. I would like to help each of them start a business. Are there alternatives to simply giving them the money that I should be considering? "

Or, perhaps...

"We would like to help each of our children buy a home. What is the best way to do this?"

And so on…

While "just giving" children, grandchildren and other family members financial assistance may not be the best approach both from a maturity, growth and development perspective, it may also have gift tax and/or generation-skipping transfer tax implications as well. Therefore, in order to navigate both the emotional and tax related aspects of financial assistance, in addition to more traditional estate planning strategies some families choose to create a "family bank" to facilitate intra-family financing.

What is a Family Bank and What Does It Do?

Although there is no precise formula that dictates the shape, context and structure of a family bank, generally a family bank is a formalized approach to providing financial assistance to family members while encouraging accountability, responsibility and an appreciation for the longevity of a family's wealth and legacy. Although the term "family bank" is often used to describe this more formalized lending structure, the family bank described here is not typically structured as a bank for regulatory purposes. Family banks often take the form of a trust or a business entity such as a limited liability company, or a combination of both. The primary mission of a family bank should be clearly defined by the family creating it, but a family bank is most often used to facilitate intra-family banking and financial development of current and future generations.

To some extent, most families have engaged in some form of family banking although it may have been informally. If you have made loans to children to purchase homes, start businesses or to provide financing for other endeavors, you have engaged in family banking. Sometimes, by formalizing these actions, accountability of the borrower and thus family harmony may be more easily maintained. Also, a more formal, long-term, well thought out approach to family banking may serve multiple family objectives, such as:

- promoting financial security and well-being without deterring the need for self-sufficiency;
- providing a means for mentoring and fostering entrepreneurial and personal financial activities of children, grandchildren, and more remote descendants without creating a sense of entitlement;
- educating extended family members on topics such as responsible borrowing, managing resources and following through on obligations; and,
- fostering the financial growth and development of future generations, which may, in turn, protect family wealth and potentially preserve the family legacy.

A family bank may be as formal or informal as a family desires. However, if the intent is to create an entity to facilitate long-term intra family lending and financing, families should consider a more formalized structure.

Structure

While some families may choose to utilize a family trust to serve as the family bank, another common approach is to combine the use of a family trust and a limited liability company to comprise the family bank.

Family Trust as Family Bank

Family trust

- Controlled by trustees
- Flexible terms to meet multi-generational needs

Provides loans and other financial assistance to:

Children, grandchildren, extended family members, future generations

While this structure may be simpler to implement and administer, it may not provide enough flexibility and diversification of oversight. For example, if family members serve as trustees and are in control of all loans and transactions made by the bank, the likelihood of family discord and mistrust of the bank may be greater. This may lead some families to choose to structure the family bank as a trust in conjunction with a limited liability company.

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The Family Bank

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Family Trust and Limited Liability Company as Family Bank

Family trust

- Controlled by trustees
- Flexible terms to meet multi-generational needs

Trust holds and funds LLC

Limited liability company—Funded with assets

- Controlled by independent body of professionals
- Governing documents may be amended to allow for flexibility
- Governing body may be removed and replaced

Trust provisions and LLC governing documents are coordinated to work together to provide loans and other financial assistance to:

Children, grandchildren, extended family members, future generations

Although there may be additional administrative complexity involved in creating a family bank utilizing a trust and a limited liability company, the ability to include independent oversight and flexibility may make this structure more desirable.

Funding the Family Bank

Funding the family bank may take place in various ways. A matriarch and patriarch may choose to fully fund a family bank by creating a multi-generation trust and funding it with their lifetime gift tax exemptions, currently $5.25 million each and $5.34 million in 2014. This pool of assets would serve as the initial asset base to facilitate loans and other transactions. The trustees would determine who, when and under what terms the bank would make loans to various family members and beneficiaries. Alternatively the matriarch or patriarch could purchase life insurance in a trust to endow a family bank which would be funded upon their deaths.

A family bank may also be funded by a collection of family members who own equity in the entity based on their initial contributions to fund the bank. The bank may be controlled by family members, or possibly by third party board members or managers selected by the family. By allowing third party decision makers to determine the bank's transactions, it may be less likely for family discord to develop because of the bank's business activities. It is important to involve multiple generations in the initial decisions regarding the creation of the bank, particularly if third party management will be used. If all age-appropriate generations have input in the structure, creation and funding of the family bank, it is much more likely that the bank will continue to facilitate the family's objectives throughout the lives of subsequent generations.

Potential Benefits of a Family Bank

Creating a family bank can provide benefits to family members for multiple generations. Families have the opportunity to take a more "hands on" approach to making loans to family members and have a mechanism to monitor financial maturity and accountability.

Providing financial assistance to family members is the most obvious potential benefit. If a family member needs capital to purchase a home, start a business or invest in a particular opportunity, the family bank may be the perfect entity to provide the capital. It is important that the lending process (e.g. application, review, approval) be consistent and professional to uphold the legitimacy of the bank. For example, a family bank may require each potential buyer to submit a formal "request for lending" in which the borrower must provide a statement which could include one or more of the following:

- what funds are requested;
- why the loan would be appropriate based on the goals and lending objectives of the family bank;
- how the loan would provide economic benefit to the family bank;
- the proposed terms of the loan;
- the borrower's confirmation and plan of repayment; and
- any other information the bank management determines is in line with the family bank's objectives.

The borrower's request would be reviewed by the decision-making body of the bank and either approved or not, as appropriate. This process allows the family to educate and hold family borrowers accountable and outlines the consequences of default in order to foster responsible financial behavior which can protect the family's wealth into the future.

Family banks may choose to begin assisting family members prior to their reaching the age of majority. While a potential borrower must attain the age of majority to borrow funds from a traditional bank, a family bank may choose to begin assisting family members in their teen years to foster work ethic, entrepreneurial acumen and financial maturity. For example, the family bank may choose to loan money to a high school age family member to fund a lawn service business he or she intends to start during summer vacation. By starting at an early age, the family can plant the seed of financial responsibility through real life opportunities.

Things to Consider

While there are many potential benefits of a formal family bank which may be very attractive to senior generations, there are also certain things that must be considered when a family is deciding whether or not to undertake the creation of a family bank. Some of these are:

- Does the family want to undertake the ongoing administration of a family bank?
- Is the family committed to maintaining the formalities and business integrity of the family bank?
- The transactions of the bank must be consistent with the desire for economic benefit and profitability of the bank. This may require the bank's governing body to say "no" to some family members' requests. Is the family prepared to deal with potential discord in these situations? Of course, utilizing independent third-party decision makers may help alleviate this issue.
- The family must consider and discuss with counsel and other tax advisors any potential tax implications which could arise in connection with the family bank.

Conclusion

Families have engaged in informal intra-family financing for many generations. Creating and funding a more formal family bank can provide a structured way to provide capital and encourage financial responsibility to multiple generations of family members.

Joyce Crivellari is a Senior Wealth Strategist at UBS who works with ultra high net worth individuals to help coordinate their investment, estate planning and philanthropic goals. Prior to joining UBS in 2008, Joyce practiced law with the law firms of Fox & Associates, LLP, in Houston, Texas and Barnes & Karisch, P.C. in Austin, Texas.

Discretionary Distributions:

Considering Other Resources

by
Charles J. Durante
Connolly Gallagher LLP

The caller is focused and insistent. She needs a distribution of principal – *again*.

It's not for tuition or elective surgery, but her tone makes clear that it's important. Home improvement is mentioned, but which home is unspecified. The requested amount isn't outrageous, but if granted, would push her distribution for the year above 7 percent of the trust.

She's savvy. She's just negotiated her third pre-nup. She knows the trust agreement better than the trust officer. "It doesn't say anything about considering other sources of income," she reminds.

Is there a more difficult task for a trustee than weighing fiercely-argued, gauzily-justified requests for principal distributions? Particularly from cagey beneficiaries who were granted removal power in the most recent decanting?

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Discretionary Distributions

(continued from p. 22)

The distribution committee is not a foolproof firewall, but provides support for harangued trust officers. Their internal guideposts, institutional memory and decades of life experience can resolve these conundrums sensibly.

A recent change in legal authority has given distribution committees an important tool that was often denied in the past.

In earlier generations, if the governing instrument was silent on the subject, a trustee didn't need to examine a beneficiary's resources in evaluating a request for discretionary distribution. Indeed, examination of a beneficiary's income and assets was often prohibited.[1]

The Third Restatement of Trusts, published in 2003 and seeping into court decisions, reversed this rule, saying that if the governing instrument does not address whether the beneficiary's resources should be considered, then they generally should be.[2]

An earlier generation's guide, the Second Restatement, published in 1959, erected a presumption that if the governing instrument were silent on the subject, a beneficiary with other resources could nevertheless be entitled to distributions for support.[3] This presumption begat a generation of irreconcilable rulings that obscured trustees' duties of prudence and impartiality.

Generally, the Third Restatement is attentive to the interests of vulnerable beneficiaries. Here it grants moral support and legal heft to arguments of remainder beneficiaries whose future nest eggs are threatened by erosion. The logic is clear. Discretionary distributions should be based on the standards in the document – and vigilance for the interests of all beneficiaries. A decision whether a distribution is really necessary for support should be based on all important facts.

Decisions in Delaware courts had hinted at this attitude, even before the Third Restatement. In the first McNeil case in 1999, the Court of Chancery stated that the trustees "had an affirmative duty to consider the needs and resources" of beneficiaries seeking distributions from a $50 million trust. "The Trustees' decision to consider the needs and resources of the Children before making a final decision on the Request was therefore reasonable and flawed only by delay."[4]

A beneficiary of another trust, whose trustee could make discretionary distributions, "having in mind [the beneficiaries'] other income and resources," was rebuffed by the Court in 1998 in her request for help to pay for her children's education, when she refused to submit financial information requested by the trustee – including for her husband.[5] While her child was presumably impecunious, if the father had the ability to pay, and otherwise would have been expected to pay, the trust's payment for his child's education would have effectively made him a beneficiary.

Evaluating distribution requests requires the trustee to engage wisdom, withstand emotions, evaluate family context and parse passages in the trust that might have been either meticulously crafted or pasted from a form book.

This is not an exercise where court cases give guidance. Texts vary widely, circumstances infinitely. Trying to interpret a trust's language from past court cases is "generally an unproductive exercise," observed Chancellor Grover Brown, among the best at divining the meaning of trusts.[6] "Precedents are substantially valueless," lamented a New York judge.[7]

Even overarching principles can collide. The Third Restatement reports a widespread view that "support and maintenance" implies the beneficiary may be maintained at the standard of living she enjoyed when the trust became irrevocable.[8] Yet, there are limits, candidly expressed by Vice Chancellor Pearson when he analyzed a mandate "comfortably to support" the testator's widow, in an era when scriveners never split infinitives. "The needs, desires and habits of the person to be supported should be given weighty consideration. Nevertheless, that does not justify an indulgence of every whim or caprice of the beneficiary. An important connotation of the expression is the idea of moderation."[9]

Such a judicial attitude helps give spine to a trustee confronted with a beneficiary seeking full support for a sixth undergraduate year at a private college. A request for a $5 million private jet is likely doomed.[10]

On the other hand, while at least one state has found a "general rule" that a beneficiary's other resources be substantially exhausted before invasion of principal is authorized,[11] this view is largely rejected as penurious and contrary to most grantors' intentions.[12]

Delaware trustees eye beneficiaries' resources in different ways. Some trustees, even if the governing instrument does not mandate taking available resources into account, require information about assets and cash flow when any discretionary distribution is requested. Some ask for tax returns in all cases. Others require only a budget and balance sheet, unless the request reaches a certain level. Yet other offices ask for financial detail only when circumstances warrant closer inquiry.

The Third Restatement approves each approach. "The trustee generally may rely on the beneficiary's representations and on readily available, minimally intrusive information requested of the beneficiary," unless "the trustee has reason to suspect that the information thus supplied is inaccurate or incomplete."[13]

(continued on p. 26)

Discretionary Distributions

(continued from p. 25)

Whatever policy they pursue, trust departments have many reasons to prevent trusts from springing unjustifiable leaks. Beneficiaries pleased with one distribution can become high-maintenance. Displeased remainder beneficiaries can become litigious.

Principal distributions should be documented and reported. Remainder beneficiaries can complain, with justification, that undisclosed principal distributions violate the trustee's duties to be impartial and to keep beneficiaries informed.[14] The Third Restatement says this means that if remainder beneficiaries ask, they are entitled to "relevant, general information concerning the bases upon which the trustee's discretionary judgments have been or will be made," with "reasonable protection" for confidential or sensitive information.[15]

Added incentive for vigilance, for institutions under its jurisdiction, comes from the Comptroller of the Currency, whose handbook for national bank examiners admonishes, "Effective risk management requires a process to ensure that the decision to make a discretionary distribution is based on standards that are fair to both the income and principal beneficiaries. ... All discretionary distribution decisions should be adequately supported, documented, and approved by an authorized authority."[16] The OCC's examiners will document their displeasure at what they perceive to be slipshod or poorly documented distribution policies.

Handling insistent beneficiaries is among the special skills of a trust officer. The increasing discretion to size up a beneficiary's financial position will sometimes provoke difficult conversations, but will ultimately help the trustee to carry out grantors' intentions more effectively.

Charles Durante brings 35 years of professional leadership to the planning of strategies for the inter-generational passage of personal and business property. He advises fiduciaries on the administration of trusts and estates, counsels foundations and other non-profit organizations, and advises clients in the areas of Delaware statutory trusts, Delaware holding companies and Delaware limited liability companies. His work includes defense in a number of will contests and litigation of significant public impact. Chuck advises many of Delaware's leading trust institutions in matters of planning, administration and risk management. He is immediate past chair of the Estates and Trusts Section of the Delaware State Bar Association and immediate past president of the Wilmington Tax Group.

Notes:

1 Martin's Will, 199 N.E. 491 (N.Y. 1936) (other resources cannot be considered in a trust for "support and maintenance").
2 RESTATEMENT (THIRD) OF TRUSTS § 50, Comment e.
3 RESTATEMENT (SECOND) OF TRUSTS § 128, Comment e.
4 Bishop v. McNeil, 1999 Del. Ch. Lexis 186.
5 Nancy W. Couch Trust, 723 A. 2d 376 (Del. Ch. 1998).
6 Wilmington Trust v. Stuart, 1983 Del. Ch. Lexis 524.
7 Estate of Anna Druck, 790 N.Y.S. 2d 837 (N.Y. Surr. 2005).
8 RESTATEMENT (THIRD) OF TRUSTS § 50, Comment d(2).
9 Equitable Trust Co. v. Montgomery, 44 A. 2d 420 (Del. Ch. 1945).
10 Wilmington Trust v. Stuart, 1983 Del. Ch. Lexis 524.
11 Guaranty Trust Co. of N.Y. v. New York City Cancer Comm. 144 A.2d 535 (Conn. 1958); Emmert v Old National Bank, 246 S.E. 2d 236 (W. Va. 1978).
12 Hart v. Connors, 228 N.E. 2d 273 (Ill. App. 1967); Demitz' Estate, 208 A.2d 280 (Pa. 1965); Farmers Bank v. Delaware Trust Co. 95 A.2d 45 (Del. Ch. 1953).
13 RESTATEMENT (THIRD) OF TRUSTS § 50, Comment e(1).
14A trustee that invaded principal without inquiring into the beneficiary's assets or standard of living can be surcharged, and its lack of communication with remainder beneficiaries counted as a demerit. Feibelman v. Worthen National Bank, 20 F.3d 835 (8th Cir.1994).
15 RESTATEMENT (THIRD) OF TRUSTS § 50, Comments b and e(1).
16 Personal Fiduciary Services, Comptroller's Handbook (2002) § 33.

A Novel Approach! A Novel Conference!

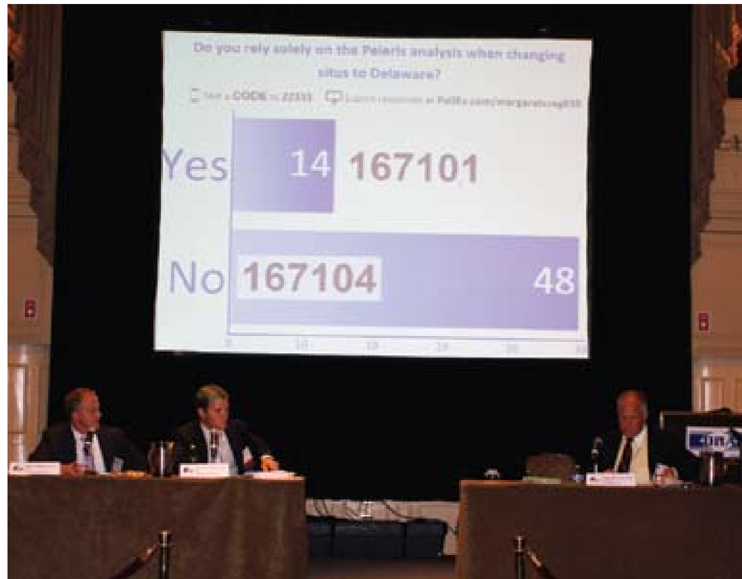
9th Annual Conference Shows Delaware Writes the Book on Trusts!

The 2014 Delaware Trust Conference, the 9th annual edition, presented a novel approach to wealth planning September 30th and October 1st at the Hotel du Pont in Wilmington. Once again the conference was attended by a capacity audience of trust, legal, and accounting professionals. The spirit of Charles Dickens introduced each panel providing timeless parallels between classic literature and the classic features of the Delaware trust product. Charles Dickens was played by British historian Glenn Mitchell who has done numerous documentary projects for the BBC. Thirty-three firms sponsored the event (see page 21). The next few pages provide a visual glimpse at some of the conference highlights.

The DBA also wishes to recognize again the following individuals who helped make the 2014 Delaware Trust Conference a great success: Cynthia D.M. Brown, Esq., President, Commonwealth Trust Company; Bridget Boyd, MBA, CFTA, Vice President, Managing Director, First Republic Trust Co. of Delaware LLC; Timothy Carroll, Esq., Executive Director, UBS Trust Company; L. Joseph Covas, Jr., Executive Vice President, Reliance Trust Company of Delaware; Jennifer A. Cuva, CTFA, Relationship Adivsor, Brown Advisory; David A. Diamond, Esq., SVP & National Trust Specialist, The Northern Trust Company of Delaware; Charles J. Durante, Partner, Connolly Gallagher LLP; Robert W. Eaddy, President & CEO, The Bryn Mawr Trust Company of Delaware; Todd A. Flubacher, Partner, Morris Nichols Arsht & Tunnell LLP; Thomas M. Forrest, CPA, President & CEO, U.S. Trust Company of Delaware; Michael M. Gordon, Esq., Partner, Gordon, Fournaris & Mammarella, P.A.; Ellisa Opstbaum Habbart, Esq., Partner, The Delaware Counsel Group LLP; Danielle M. Kiss, Vice President, JPMorgan Trust Company of Delaware; Anne Marie Levin, J.D.,LL.M, CTFA, Key National Trust Company of Delaware; Carlo Lombardi, Esq., Vice President, Wilmington Trust Company; Mark V. Purpura, Esq., Director, Richards, Layton & Finger, P.A.; Nicole M. St. Amand, CTFA, Assistant Vice President, Wilmington Trust Company; Anne Schumeyer, Vice President, PNC Delaware Trust Company; Vincent C. Thomas, Esq., Partner, Young Conaway Stargatt & Taylor, LLP; Lynn Welch Watson, CFP, EA, Vice President, Senior Trust Officer, Brown Brothers Harriman Trust Company of Delaware; Kalimah Z. White, Vice President, JPMorgan Bank.

Paul S. Lee, National Managing Director, Bernstein Global Wealth Management addresses the audience on "The Intersection of Estate and Income Tax."

James H. Cundiff, Partner, McDermott Will & Emery, listens as moderator Charles J. Durante, Partner, Connolly Gallagher LLP, addresses the topic of State Income Taxation.



(l to r) Todd A. Flubacher, Morris, Nichols, Arsht & Tunnell LLP; Vincent C. Thomas, Young Conaway Stargatt & Taylor, LLP; and Thomas M. Forrest, U.S. Trust Company of Delaware conduct a text poll, new to this year's event.

Paul J. Chew, Head of Investments, Brown Advisory, speaks on "Investing Client Assests in a Low but Rising Interest Rate Environment."

"Pearls or Perils of Wisdom?" (l. to r.) Chief Justice Myron T. Steele, Retired: Delaware Supreme Court; Peter S. Gordon, Director, Gordon Fournaris & Mammarella, P.A.; Collin J. Seitz, Jr., Partner, Seitz Ross Aronstam & Moritz LLP; and, W. Donald Sparks II, Director, Richards Layton & Finger, present a compelling presentation on the Peierls Decisions.

Delaware Trust Conference

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Dan Urgo, Vice President, Wilmington Trust; Deborah Markwood, Director, Trust Consultant, UBS Trust Company, N.A., and Craig Walling, CEO & Chairman, UBS Trust Company, N.A. at Tuesday Evening's Reception.

(l. to r.) Robert A. Glen, Delaware State Bank Commissioner; David G. Bakerian, President, Delaware Bankers Association; U.S. Senator Chris Coons; and, Rodger Levenson, Executive Vice President, WSFS Bank, Chairman,Delaware Bankers Association attend Tuesday evening's reception.

(l. to r.) Elizabeth W. King, Executive Director, J.P. Morgan Trust Company of Delaware; Jerome K. Grossman, Partner, Young Conaway Stargatt & Taylor, LLP; and Robert W. Eaddy, President & CEO, The Bryn Mawr Trust Company of Delaware, discuss Entity Usage with Trusts.

Tash Perrin, Senior Vice President, Senior Director, Chairman's Office, Trust, Estates and Wealth Management Services, Christie's makes a point during the panel on Specialty Asset Administration as moderator Trisha W. Hall, Partner, Connolly Gallagher, LLP, and Hollie Gorman, Private Client Advisor and National Personal Lines Leader, Brown and Brown Private Client Group look on.

Delaware Trust Conference

(continued from p. 33)

(l. to r.) Dana G. Fitzsimons, Jr., SVP, Fiduciary Counsel, Bessemer Trust; and George W. Kern, Managing Director, Regional Director, Bessemer Trust Company of Delaware, N.A. listen as Sharon L. Klein, Managing Director of Family Office Services & Wealth Strategies, Wilmington Trust makes a point during the Trust Litigation and Legislative Update panel.

A Matter of Trust

Frank Aragona Trust Sheds Light on "Material Participation" Requirement

by
Matthew P. D'Emilio, Esq.
and
Jennifer E. Smith, Esq.
Cooch & Taylor, P.A.

With the enactment of IRC § 1411 last year, which imposes a 3.8% tax on net investment income ("NII"), the "material participation" exception to the passive income loss rules has become increasingly important, especially with respect to trusts holding specialty assets. For trusts, § 1411(a)(2) imposes a tax equal to 3.8% of the lesser of: (i) the trust's adjusted gross income in excess of the highest income tax bracket threshold ($12,150 for 2014), or (ii) the trust's undistributed net investment income. This revenue-raiser was enacted to offset the cost of the Affordable Care Act, and is intended to level the playing field between taxes on investment income and wages.

Material participation is key to determining whether income from an investment in a pass-through entity is passive or non-passive. The 3.8% tax applies to income from passive activities, and not to income earned from an active trade or business.

Until recently, there has been scant guidance as to what constitutes material participation by a trust, and that which was available has not been particularly favorable to trustees. However, the Tax Court's recent trust-friendly decision in *Frank Aragona Trust, et al. v. Commissioner*, 142 T.C. 9 (2014) sheds light on the material participation exception for trusts, and contradicts the IRS's unfavorable and long-standing positions in private letter rulings and a recent technical advice memorandum.

In *Frank Aragona Trust*, the U.S. Tax Court held that a trust can qualify for an exception to the general rule that rental income is *per se* passive if the trust materially participates in the real-property trade or business. The Tax Court's decision was based in large part on the fact that three of the six trustees of the trust participated in the trust's rental activities on a full time basis. Importantly, the Tax Court expressly rejected arguments by the IRS that trusts cannot, as a matter of law, meet the exception, and that the Tax Court should ignore the activities of trustees who are employed by trust-owned entities or who own minority interests in entities through which the trust operated.

Frank Aragona Trust provides guidance for trusts on material participation, and undoubtedly will lead to many creative trust structures, including the possible appointment of special trustees, in an attempt to avoid the 3.8% tax on NII.

Nevertheless, *Frank Aragona Trust* has left many questions unanswered. While the Tax Court favorably ruled that the activities of trustees can satisfy the material participation requirement, it declined to address whether the activities of trust employees, as opposed to trustees, can satisfy the requirement, how much activity constitutes "material participation" and whether the activities of several trustees can be aggregated. These issues will provide fodder for regulations and additional court decisions.

DBA Calendar of Events

For more information on these and other programs visit ***www.debankers.com***, or phone the DBA at 302-678-8600, or email: debankers@debankers.com

November 2014

November 18th - 20th – 2014 Regulatory Compliance School. Wilmington/ Christiana Hilton, Newark, DE. The Delaware Bankers Association and FIS Enterprise Governance, Risk & Compliance (EGRC) Solutions present the 2014 Regulatory Compliance School offering a Comprehensive Review of Federal Laws & Regulations Affecting the Financial Services Industry. Approved for 14.30 DE CLE CREDITS and 18 CREDITS PA CLE!

December 2014

December 9th - BSA/AML for Financial Institutions. 8:30 - Noon. University & Whist Club, Wilmington, DE. The Delaware Bankers Association and FIS Enterprise Governance, Risk & Compliance (EGRC) Solutions are please to present a special half-day seminar designed to address the specific needs of financial institutions in fulfilling their Bank Secrecy Act/Anti-Money Laundering training requirements. In addition to the live presentation, a CD of the presentation will also be available to take back and fulfill office staff training.

March 2015

March 4th - 6th – 2015 DBA Executive Officer Visit to Washington, DC. This highly acclaimed event for top-level bank executives provides an extraordinary opportunity to meet with the key federal regulators as well as with our industry's representatives at the American Bankers Association in Washington, DC. In addition, we also meet with the entire Delaware Congressional Delegation. This year, DBA participants will be staying at the historic Willard InterContinental Hotel, 1401 Pennsylvania Ave NW, Washington, D.C. 20004. Sponsorship opportunities are available. Please contact Greg Koseluk or Margaret Cregan for more information on sponsorships.

Delaware Bankers Association/Financial Education Alliance

Web and CD Seminars

For more information, or to register, please visit the Web Seminar link at www.debankers.com. Many of the live seminars below are also available as On-Demand sessions. DBA webseminars are provided by ConferenceEdge. When registering for some webinars, members will be directed to a new site. All users will be asked to enter a user name and password to view the event catalog and to register. Webinar attendees may access the webinar for 30 days following the broadcast.

November - December 2014

November 12 - Compliance for Commerical Lenders

November 13 - Call Center Security: Dialing for Dollars

November 14 - Loan Documentation: Top 10 Mistakes & Top 25 Questions

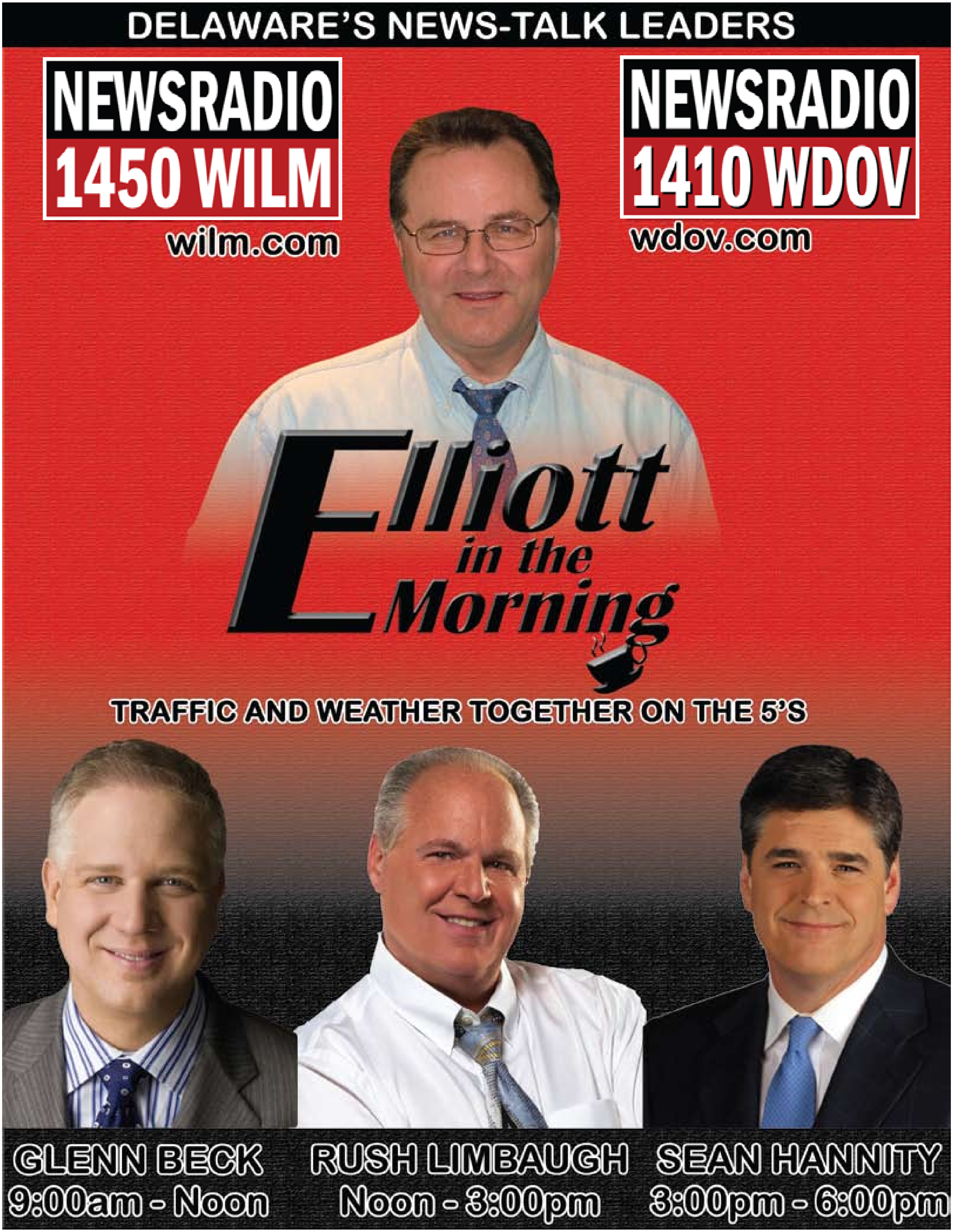
November 17 - Federal Benefit Payments Garnishment Requirements: Eight Frequently Asked Questions

November 19 - Salesmanship for Lenders

November 24 - Strategic Loan Pricing

November 25 - IRS Part 1: Your Bank's IRS Compliance Program, Lending Related Returns & Reporting of Miscellaneous Income

December 2 - IRS Part 2: Deposit Related Returns, New Nonresident Alien Reporting Requirements, Backup Withholding (B & C Notices) & Common Mistakes in TIN Matching Procedures


DELAWARE'S NEWS-TALK LEADERS
NEWSRADIO 1450 WILM
wilm.com
NEWSRADIO 1410 WDOV
wdov.com
Elliott in the Morning
TRAFFIC AND WEATHER TOGETHER ON THE 5'S
GLENN BECK
9:00am - Noon
RUSH LIMBAUGH
Noon - 3:00pm
SEAN HANNITY
3:00pm - 6:00pm

Lenders Beware – Don't Overlook the Landlord's Lien!

by
Eugene A. DiPrinzio, Esq.
Young Conaway Stargatt & Taylor, LLP

"Usually a lender will only search the public records to determine if there is a competing lien on certain collateral."

Background

Many asset-based lenders finance furniture, fixtures, and equipment for business borrowers who utilize that personal property in their trade or business located in commercially leased premises. Those same lenders sometimes overlook the impact of a landlord's lien upon their security interest in the collateral being financed. A landlord's lien is an inchoate statutory lien against all the tenant's personal property located on the leased premises, which frequently relates back to the commencement date of the lease and is superior to any other lien upon the tenant's property, with the exception of (1) liens that may have been perfected prior to the property being brought on to the leased premise or (2) most federal tax liens. Even purchase money security interests (where a lender lends money to actually purchase the collateral) are subject to competing priorities when the purchase money security interest is created after the lease (See for example, 25 Delaware Code Section 6303, which provides for a landlord who is owed rent to attach or even seize a tenant's property to the extent necessary to satisfy a tenant's rent obligations for a period of up to one year). Under those circumstances, a judgment in favor of the landlord will result in a sheriff or other judicial officer scheduling a sale so that the tenant's property can be sold and the proceeds applied towards the rent obligation. Usually a lender will only search the public records to determine if there is a competing lien on certain collateral. Often overlooked is the fact that a landlord is not required to take any steps to perfect its lien as the lien exists solely by virtue of its creation under the lease and by the particular State statute.

What Steps Should a Lender Take to Address the Landlord's Lien?

A lender should have a clear definition and description of the collateral. Before making the loan, examine the tenant's lease and determine if the tenant has a right to utilize asset-based financing and/or grant security interests in its personal property. Once the priority of a lender's security interest is established, it is important that a landlord either waive or subordinate its lien to that financing. A written landlord's waiver is utilized and negotiated so that the lender can store its collateral in the leasehold premises until it can be removed and/or scheduled for sale if the financing is not paid. If the tenant does not pay the landlord its rental obligation, the lender should attempt to negotiate an optional right to cure those obligations so that the property and/or leasehold is not extinguished before the lender takes back or sells its collateral. Properly worded, a waiver will protect a creditor's security interest in the tenant's collateral and provide the lender with comfort that its collateral will not be sold to pay a rental obligation, as opposed to the loan.